Energy Bar Association
4th Annual Midwest Energy Conference
" Is the FERC Keeping Its Part of the Regulatory Bargain?"

by
William L. Massey
Commissioner
Federal Energy Regulatory Commission

Kansas City, Missouri
February 8, 2001

I. Introduction

Good afternoon. It is a pleasure once again to be here in Kansas City to address this excellent annual conference. The transition to competitive electricity markets has indeed been a time of turmoil. We've encountered some unexpected and shocking events that perhaps, in hindsight, we should have seen coming. We must devote ourselves now to whatever lessons we can learn from those events, and apply those lessons to attain competitive wholesale electricity markets that bring benefits to consumers, markets that promote the nation's economic well being and do not bleed consumer pocket books.

Moving to competitive electricity markets represented a significant policy shift. The Federal Power Act finds that generating and transmitting electricity are affected with a public interest and should be appropriately regulated. For most of the twentieth century, protecting that public interest was accomplished by regulating electricity on a cost of service basis. Beginning late in the century, technological change and some poor performance under regulation indicated that competition should be able to do a better job of furthering the public interest. The FERC strongly promoted competitive power markets, and during my tenure on the Commission, I have championed our pro-competition policies. The FERC focused on opening up wholesale markets, and encouraged the states to consider restructuring their retail markets for competition.

States and retail consumers understandably regard any degree of restructuring of their jurisdictional markets as a risky undertaking. Restructuring means entrusting the welfare of retail ratepayers to FERC's stewardship, and transferring some degree of jurisdiction to the FERC. This is true even if a state does not opt for retail choice. Even the limited reform of requiring the unbundling of generation from wires within a corporation and a reliance on IPPs and wholesale marketers for the electricity commodity results in a transfer of jurisdiction. Even if a state merely encourages its jurisdictional utilities to purchase power in wholesale markets, it is trusting FERC's market stewardship.

Recently one of my state colleagues - - a commissioner from a Midwestern state - - pointed out to me that to merit this trust, there must be an implied yet somehow enforceable bargain between the states and the FERC. The bargain is this: in exchange for a state's reliance upon FERC, then FERC must fulfill two obligations. One of them is to rationalize the transmission grid to ensure that it supports well functioning and non discriminatory regional power markets. A good wholesale market platform is essential. And the second part of the bargain is that FERC will take all necessary action to ensure that wholesale markets produce just and reasonable prices, especially if those markets fall into serious disequilibrium or if market power is present.

After giving this notion of a bargain some thought, I must say I wholeheartedly agree. Given the split jurisdiction and responsibilities of Federal and state regulatory functions, this is the only basis upon which competitive reform can occur. The states and retail consumers must have confidence in wholesale electricity markets before they will proceed with restructuring. Right now, about half of the states have committed to restructuring their retail markets (although some seem to be backing off) and must, therefore, rely upon this implied regulatory bargain.

My question today is this: has the FERC upheld its end of the bargain? Are the states and consumers justified in relying upon FERC?

II. Rationalizing the Transmission Grid

Let me first address the transmission grid. FERC has a mixed record on rationalizing the transmission grid. We've issued two major policies in this regard. One of them was the combination of Orders 888 and 889. Those orders were largely successful in eliminating some of the more blatant forms of discrimination regarding access to the grid. However, our open access rule did nothing to address the splintered way in which the grid is operated and was not successful in eliminating some of the more subtle ways monopoly power is exercised on the transmission grid. In most regions, power markets remain balkanized and poorly organized. To solve these problems, we need RTOs.

I firmly believe that RTOs consistent with FERC's vision in Order No. 2000 are absolutely essential for the smooth functioning of electricity markets. RTOs will eliminate the conflicting incentives vertically integrated firms still have in providing access. RTOs will streamline interconnection standards and help get new generation into the market.

RTOs also improve grid management. Eliminating pancaked transmission pricing will enlarge markets, and a truly regional approach to congestion management can lower costs and increase the amount of capacity available to the market. RTOs will also serve as a regional forum for planning. By expanding the scope of markets, rationalizing access and interconnection, and facilitating planning and grid expansion, RTOs will help ensure smoothly functioning wholesale electricity markets.

Unfortunately, our RTO policy has been great in concept but woefully inadequate in execution. The fundamental error the Commission made was to choose a voluntary approach to RTO formation. As a result, what we now have before us is a hodgepodge of design and compliance with Order No. 2000. Given this patchwork of proposals and our reliance on voluntary compliance, the Commission is now weakening the Order No. 2000 standards in order to get some RTOs in place. It is no secret that I am deeply concerned about this policy shift.

One area particularly vulnerable is the scope and configuration of RTOs. To realize their many potential benefits, RTOs must be truly regional in scope - - large and well shaped. Yet, this is the least clearly defined of the requirements in

Order No. 2000. How we treat sub-optimally sized RTO proposals will prove crucial to the development of well functioning markets. Markets are regional in scope and require seamless trading. This is not possible if transmission services and standards remain at an inferior sub-regional level.

Unfortunately, the Commission's resolve on RTO scope and configuration is weak. The Commission recently decided to accept the proposed scope and configuration of the Alliance RTO. I dissented from that order. I believe it is a significant policy mistake.

Right now, Alliance is shaped more or less like a serpent that stretches from the Great Lakes to the Mid-Atlantic. In earlier orders, the Commission expressed strong concern that his configuration separates buyers and sellers that constitute predominant west to east trading patterns, and can act as a strategically located toll gate. But the Commission's recent order accepts this configuration on the grounds that Alliance is working on interregional coordination, otherwise know as seams agreements, to smooth the way for market trading.

The Alliance order elevates seams management agreements to the status of a complete substitute for the basic characteristic of adequate scope and configuration. This is a mistake. The actual shape of the RTO is important. For example, managing loop flow across a broad region requires a shape that can generally internalize the bulk of the loop flow.

I do not believe that mere seams agreements with neighboring control areas will be capable of addressing all inadequacies of a flawed scope and configuration. If seams management agreements were sufficient, there would be no need for any scope and configuration requirements at all. Yet, achieving the reliability and other benefits of RTOs depends on the ability of the RTO to control all of the transmission facilities in an appropriate region. The more seams arising from too small or from poorly configured entities, the more dysfunctional the market.

While Order No. 2000 includes a requirement for interregional coordination, this was never intended to be a substitute for adequate scope and configuration. What was intended is that once there is an appropriately configured RTO, that RTO must coordinate with other appropriately configured RTOs.

If we are going to rationalize the transmission grid to support well functioning wholesale markets, we must insist on strict adherence to the standards of Order No. 2000. Right now, I am pessimistic about our upholding this part of the implied bargain with the states.

Why am I pessimistic? Eight Midwestern states intervened in the Alliance proceedings and pleaded with the Commission to insist upon one RTO for the Midwest – a merger of the Midwest and Alliance. They argued that Alliance was poorly configured. As they saw it, it was part of the bargain for FERC to insist upon one large and well structured midwestern RTO. Yet the Commission failed to insist that such an institution be formed.

Will the Commission exhibit greater political will when it comes to the issue of RTO independence? Will we insist that RTOs provide a place at the table for not-for-profit transmission owners such as municipals and cooperatives? Will we require adequate operational control?

As we deal with the patchwork of proposals before us, I would encourage state Commissions and market participants to hold our feet to the fire. Insist that we keep our part of the bargain.

III. Ensuring Just and Reasonable Wholesale Prices

Now let me turn to the second part of the regulatory bargain: ensuring just and reasonable wholesale market prices. If the states cannot depend on the wholesale market regulator to ensure reasonable prices for consumers, then states will surely think twice before heading down the restructuring path.

How well is FERC upholding this part of the bargain? Again, FERC's performance has been mixed. Eight of the eleven western governors would certainly give FERC a failing grade. I noted that in New York Governor Pataki's recent state-of-the-state address, he argued that New York electricity prices have been too high, and that the state had ceded too much control to federal jurisdiction. The Commission must heed these no confidence votes.

The task of ensuring reasonable prices in wholesale markets must be addressed by FERC far differently now than under the old regime. It's much

harder now. Our focus is no longer the costs of individual companies. Instead, our focus is on markets and ensuring that they are free of market power and have the needed components to function well. This means that we must have the data, the analytic capability and the manpower to recognize market power when we see it. This is tough stuff. It is cutting edge. FERC has yet to instill confidence in this policy area.

First, we need to upgrade our anachronistic analytic standards. For starters, the Commission still uses the antiquated "hub and spoke" method of evaluating market power when awarding market based rates. This method takes no cognizance of various load levels or of costs or prices of competitors, nor does it take into account transmission capacity when evaluating supply to a market. Any market participant that cannot pass this test needs a new lawyer. How accurate can this test be? How much faith can state commissioners have in our market based pricing policy if we still use this horse and buggy analytic approach? Relying upon the hub and spoke is sheer folly.

Second, the Commission must identify and clearly define what constitutes an exercise of market power. Is it market power when a generator regularly bids above its variable operating costs? I say yes, but the record in our California proceeding indicates there is no consensus on this issue. We need to develop clear standards for what is not acceptable market behavior. We cannot expect players to follow the rules when the rules haven't even been posted. And we must ensure that markets are adequately monitored and that the monitoring and policing task is equipped with the right data and with sufficient manpower to do the job. We must be market police who exercise the political will and use the firepower necessary to do their jobs rigorously. And when market monitors in California and elsewhere tell us that market power is being exercised, we must not ignore there pleas. We must forcefully respond.

Third, we must aggressively intervene when the markets are not producing reasonable prices. New electricity markets need a lot of attention. They are just emerging from almost a century of monopoly regulation. Moreover, the unique characteristics of electricity make the markets exceptionally vulnerable to market power and to the potential for breathtaking price run-ups when supply is short. Billions of consumer dollars are at stake, so we must conduct tough-minded investigations. We have to be willing to impose a time out on markets that are not

functioning. Even the venerable New York Stock Exchange uses circuit breakers to mitigate exceptional fluctuations. When the stock market drops by a set percentage, the NYSE halts trading. In fact, all of the world's most sophisticated commodity markets have time outs.

FERC has yet to demonstrate the political will for these tasks. I take the current situation in the West as a case in point. This market crisis began last June with California's clearly dysfunctional market. On December 15, we found that the California market rules in combination with the imbalance of supply and demand have caused, and will continue to cause, unjust and unreasonable prices. Yet we failed to provide any effective relief from the staggering wholesale prices, and another $3 billion has bled from the California economy since our order.

And the problem has now become a regional problem of high prices and very short supply. There are a number of measures that need to be taken to deal with this imbalance. Clearly, supply must be increased, but that may take a few years. Forward contracts must be negotiated. The information I've been receiving points in the direction of an even greater catastrophe for this summer.

Bringing forth new supply takes time in this industry. In the mean time, should we just let the unfettered high prices continue?

I say no. FERC should call a time out now. The price shocks of short supply threaten serious economic dislocation in the region. Already factories are closing and utilities throughout the region are asking for exceptional rate increases. Bonneville is doubling its rates to cover purchased power costs: the City of Takoma, Washington, has voted a 50-70 % increase. State regulators are put in a tough spot. Refusing the price increases could threaten their utilities with bankruptcy. But allowing the rate increases could unleash a political backlash from consumers who think the prices in the wholesale markets are a blatant rip-off.

I think it's time for the FERC to consider a temporary cost-based price cap on spot market sales in the western interconnection. Such a price cap could be calculated on a generator-by-generator basis at each generator's variable operating costs plus a reasonable capacity adder perhaps in the range of $25/mwh. New generation sources should be exempt. In addition, such a cap should have a well

specified sunset provision, tied either to a date certain or the attainment of certain specific conditions, such as some measure of adequate reserves.

Such a price cap would allow generators to recover all their operating costs plus a return, would restore trust and credibility to the wholesale market prices, and thereby make any rate increases politically saleable. I do believe part of the answer to this crisis lies in consumers seeing more accurate prices, but there is no purpose in charging the kind of spot prices we've seen lately. Surely suppliers have gotten the message by now that supply is needed. They no longer need such extreme signals. And consumers don't have the ability to react to such high prices in a meaningful way right now.

In short, the price signal has been sent in spades. You'd have to be on another planet not to know that the west is capacity short. Professor Paul Joskow is quoted in today's Wall Street Journal asking the rhetorical question, "If the price goes to $100,000 per megawatt is that going to increase the speed with which they build a new power plant in California?" Of course not.

These high prices serve only to continue a massive wealth transfer out of the region. Is it worth dragging down an entire regional economy, or perhaps even the national economy, for the theoretical purity of unfettered price signals? I say no. I call on my fellow commissioners to consider a time out now. It's our statutory obligation, and part of the regulatory bargain. Officials in California and elsewhere in the West feel that we have abandoned them. Governor Locke of Washington has interpreted FERC's refusal to consider price caps as "saying we're out on our own." I am very concerned about forcing the states into that position. It is bound to set competition policy back. FERC's timidity and hands-off approach is eroding consumer confidence and destroying the consensus that heretofore supported a market base approach. Just look at the California plan. It appears that California is headed for a government run electricity business for quite a while. They clearly do not trust FERC to uphold its end of the regulatory bargain.

IV. The States' Side of the Bargain

Responsibilities lie on both sides of that same bargain. When states do decide to restructure, they must ensure that the state jurisdictional components of a well functioning market are in place at the time of restructuring. FERC's authority to ensure good markets is limited by state authority.

One component the states should ensure is demand responsiveness to prices. Without the ability of end use consumers to respond to price, there is virtually no limit on the price suppliers can fetch in shortage conditions. Consumers see the exorbitant bill only after the fact. Instilling demand responsiveness into electricity markets requires two things: customers must be able to see prices before they consume, and they must have reasonable means to adjust consumption in response to those prices. Accomplishing both of these on a widespread scale will require technical innovation. But it may not take too much to make a difference. A recent study by EPRI indicates that during this past summer, a 2.5% demand reduction at peak times could have reduced energy costs in California by $700 million. Other studies show that price spikes can be reduced by 73% if just 10% of demand is on real time pricing. Better price signals allow consumers to adjust consumption in response. This can help mitigate market power exercises, especially during peak periods, and it can help spur conservation that can mitigate the need for added supply. State action is needed to bring about these benefits.

And once there is a significant degree of demand responsiveness, demand reduction aggregators should be allowed to bid so called "negawatts" into organized markets along side the megawatts of the traditional suppliers. This direct bidding would be the most efficient way to include the demand side in the market. Demand aggregators would bid a price which, if paid, would cause users not to consume power for that hour. Market design simply cannot ignore the demand half of the market without suffering the consequences, especially during shortage periods.

A second component of a well functioning market is a structure that is conducive to needed supply. One thing that is needed is an *ex ante* assurance of adequate generating capacity, including a reserve margin. Given that electricity cannot be stored, relying solely on market signals for capacity could mean significant fluctuations of price and capacity availability as supply and demand

adjust. One way of guarding against these fluctuations would be to place a reserve requirement on the load serving entities that they could meet however they see fit. This is the current practice in PJM, and, given the level of capacity additions planned there, suppliers seem to have confidence in that market design. However expressed, the responsibility for assuring adequate supply must be explicit.

The other aspect of supply that is in the hands of the states is a siting and certification process that allows capacity to be built in a timely manner. This could be new generation, including distributed generation, or new transmission investment, including technological improvements to existing wires. We cannot escape the fact that adequate facilities are needed, regardless of market design, and these state certificated facilities are needed for good wholesale markets to flourish and benefit consumers.

I urge both Federal and state regulators to uphold their respective ends of the regulatory bargain.

V. Natural Gas Policy

Speaking of supply, much of the needed new generation capacity will be gas fired. This means that we need an adequate supply of gas and a well functioning infrastructure to deliver that gas to the new plants. I would like now to turn to some of the current gas issues FERC is addressing.

With all eyes seemingly fixed on the problems in California, natural gas markets have also displayed significant price volatility over the last six months or so. Nevertheless, I have somewhat greater confidence in gas markets. My confidence is based on several factors, including nearly eight winters' experience with natural gas restructuring and an internal process at the Commission aimed at ensuring that pipeline capacity expansions meet the demands of a growing natural gas market.

The success of the natural gas industry may be due, in part, to the fact that the era of open access has spurred the creation of new pipeline services that enhance system reliability, such as parking and lending services and hourly services. Third party service providers, particularly storage providers, also

provide options for customers that enhance system reliability. Currently, natural gas is traded at over 60 hubs throughout North America and is delivered to LDCs and end users over an extensive pipeline system. Daily price information is available for some 112 trading points in Gas Daily. Natural gas markets are substantially more open, liquid and transparent than electricity markets.

The interstate portion of the nation's pipeline grid, the part regulated by the Commission, consists of about 280,000 miles of pipeline delivering gas to thousands of delivery points nationwide. The Commission is heavily invested in ensuring that its certificate process functions efficiently so that pipe will be in the ground when and where it is needed. Since joining the Commission in 1993, I cannot remember a single instance where the Commission failed to issue a certificate to a project that met the Commission's minimum filing requirements. Certainly, there have been instances where the Commission has imposed rigorous environmental and other conditions that were warranted by the nature of the comments and protests we received. Over the years from April, 1994, to September, 2000, the Commission certificated almost 10,000 miles of new and replacement pipeline. Moreover, the Commission has taken concrete regulatory steps to expedite the certificate process through our Certificate Policy Statement issued in September, 1999, and in streamlining regulations governing construction under the Commission's blanket certificate program. Over the last two years, the Commission has reduced the average processing time for unprotested cases from 108 days to 95 days. Even for cases that do raise precedential issues, the Commission has seen average case processing time reduced from 300 days to 210 days.

For the past eight years, FERC regulated gas markets have provided mostly good news for consumers. Nevertheless, I see some red flags that make it imperative for the Commission to approach our regulatory mission with caution and thoughtfulness. I have followed closely the price volatility that has plagued natural gas markets for the last six months. With the increase in rig count from its two year low of 371 in April 1999 to 840 by November, 2000, there should be more gas available to serve the nation's gas needs. Fortunately, there are signs that prices are moderating, partly due to the warmer than expected temperatures in much of the nation's consuming regions since late January and concomitant easing of heating demand. Nevertheless, the Energy Information Administration estimates that winter (October 2000 - March 2001) natural gas prices at the

wellhead will average about $ 6.14 per Mcf, more than two and one half times the price of the previous winter heating season.

Another red flag was raised last week in the form of a complaint filed by the National Association of Gas Consumers against "All Sellers of Natural Gas in the United States of America in Interstate Commerce." The gist of the complaint, which has been widely reported in the trade press, is that the Commission should set a nationwide wholesale price cap of $ 2.74/ per Mcf for natural gas. The Commission's jurisdiction over wellhead prices is severely limited. Nevertheless, the Commission must consider all complaints carefully. In order No. 637, the Commission waived the price cap for short term firm released capacity until September 30, 2002. I viewed it as an experiment and will be watching natural gas transportation markets very carefully between now and the expiration of this temporary measure.

In addition to the impact of price volatility on energy markets, the Commission also continues to hear allegations of market abuses by pipeline marketing affiliates, which is an important red flag that warrants our attention. We are investigating complaints concerning El Paso's marketing affiliate and pipeline capacity into California. Over the last year or so, we have conducted enforcement actions against Columbia, Columbia Gulf and Kinder Morgan, all of which involve their marketing affiliates. Although it is our hope that the abuses we found are the exception rather than the rule, they serve as reminders that the Commission has a crucial interest in monitoring energy markets and the actions of both regulated entities and their affiliates. To that end, the Commission will hold a technical conference on March 15 to consider whether our pipeline affiliate rules have kept pace with the times. Although Staff has not completed its plans for how the technical conference will be conducted, I expect that an announcement will be issued in the very near future. Some of the issues that will be considered are the effectiveness of the Commission's current affiliate regulations, whether all pipeline affiliates should be covered by the rules, the potential anti-competitive or discriminatory impact of affiliate transactions, and alternative approaches for dealing with affiliate issues.

Finally, the Commission is making progress to implement Order No. 637's requirements that pipelines develop and offer imbalance management tools instead of penalties. Commission staff have convened technical conferences (and often

follow-up technical conferences) for most of the interstate pipelines. The next phase, which is in process now, is for the pipelines to file revised tariff sheets containing their proposals for imbalance services and to provide an additional opportunity for public comment. Thus far, some common themes, such as the feasibility of capacity segmentation, have emerged. Settlement discussions are underway on a number of pipeline systems, but it may be several more months before the process is completed for all the interstate pipelines.

VI. Conclusion

In conclusion, the issues seem to get harder, not easier. Keeping our part of the bargain is critical. I look forward to working with state regulators and all market participants to solve these problems.